BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Integrate Procurement Policies and Consider Long-Term Procurement Plans	)	R.06-02-013

SAN DIEGO GAS & ELECTRIC COMPANY (U 902-E)

VOLUME II

TESTIMONY ON SELECTED PROCUREMENT POLICY ISSUES

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TESTIMONY ON SELECTED PROCUREMENT POLICY ISSUES

Section I.

A. Introduction

Pursuant to the Commission's direction in this proceeding, Volume II contains SDG&E's testimony regarding particular procurement policies and certain changes that SDG&E believes would improve procurement going forward. The order, headings and italicized questions are taken verbatim from the Commission's outline for Volume II in Attachment A to the Scoping Memo issued in this proceeding. SDG&E also advocates in Section IV below several important additional changes related to procurement regarding debt equivalence methodology, FIN 46 (R) financial consolidation, use of bilateral contracts, use of RECs, and streamlining of regulatory oversight.

B. Discussion on Recent/Upcoming Policy Issues (McClenahan)

Identify the impact of resource adequacy on costs and procurement practices. Describe how the local resource adequacy requirement will affect procurement in the coming years.

SDG&E identifies two important considerations that must be implemented with regard to resource adequacy (RA). First, RA must be fully reflected in the cost of procurement of renewables. For example, if intermittent resources such as wind require that the utility backstop the capacity portion of a contract, then such RA backstop costs must be fully reflected in the least-cost best fit analysis of these resources. SDG&E intends to include these and other "integration" costs in all future procurement evaluations, and the Commission should expressly confirm that this is a valid approach.

Second, over time, local RA procurement may lead to "overprocurement" of system RA due to pre-existing "legacy" contracts if additional transmission capacity is not added. To illustrate this point, if a utility has some portion of its portfolio of supply resources located remotely from its system through long-term contracts, the need to contract for additional megawatts of capacity solely to meet local RA needs will lead to an excess of total portfolio supply. This circumstance will become rationalized over time as legacy contracts expire and are replaced with more local contracts, however a functioning capacity market could also help mitigate this over-procurement cost. SDG&E recommends, therefore, that the Commission move as expeditiously as possible with the creation of a centralized capacity market to help address this problem, making it a priority among the issues being addressed in R.05-12-013.

Describe how the proposed GHG emissions performance standard will affect procurement practices.

Similar to the introduction of a local RA requirement, the rapid implementation of GHG reduction requirements could lead to stranded assets if legacy, higher-emitting resources or contracts need to be replaced with redundant, lower-emitting capacity in order to achieve GHG reduction goals prior to existing contract expirations. This situation would occur if the total portfolio GHG emissions from existing resources exceeds Commission-adopted targets, resulting in a constraint in any least-cost best fit evaluation of procurement options. SDG&E therefore urges the Commission to use a flexible compliance mechanism to meet GHG targets, and to take a leadership role in the creation of international trading mechanisms.

The Commission should also work with sister agencies to ensure that each sector plays an important role in implementing the State GHG policy of achieving a reduction in

GHG to 1990 levels. The utility sector should not be required to undertake mitigation (and impose the cost of that mitigation upon its customers) that is disproportionate to the energy sector's contribution to the State's GHG emissions. If any utility does more than its proportionate share, it should be given the ability to sell excess GHG reductions to those entities that cannot meet their reduction obligation through technological fixes applied within their industry. This ability would allow ratepayers to be compensated for their over-compliance activity and may incent IOUs to do as much as possible to realize ratepayer value from such efforts. Recall that the Commission's GHG program development began in part as the Commission's response to the AB 57 provision addressing incentive mechanisms.

Describe impact of MRTU implementation on procurement practices and procedures.

While MRTU will be a seachange for the ISO's systems and operations, its impact on SDG&E procurement as outlined in this LTPP will be minimal. The changes in MRTU will be limited to the mechanics of scheduling and settlements. It will not significantly alter the major elements of this plan, such as SDG&E's positions or the manner in which SDG&E procures because IOUs are encouraged to procure most of their resources outside of spot markets. The MRTU markets will provide additional useful information regarding the costs of generation and transmission additions, and SDG&E's LTPP calls for including congestion costs in the evaluation process. With the introduction of an ISO day-ahead market (which would fall within the Commission definition of "spot" markets), SDG&E suggests that the Commission abandon the current guideline of "5% or justify" in the spot market.

Describe how the expiration of DWR contracts over the planning horizon is affecting utility planning. Highlight the magnitude of DWR contracts in the IOU's existing resource portfolio and highlight their expiration dates.

SDG&E has a total of about 1,400 MW of DWR contracts in its portfolio. These contracts are a combination of peaking units, a combined cycle plant, firm LDs and wind power. These contracts step down over the next several years and will be gone from the portfolio in 2012, except for the wind power, which ends in 2013. The contracts, capacity, and end dates are shown in the Table below. The capacity and energy amounts and expiration dates can also be seen in Exhibits IV-1 through IV-4. The needs identified in this LTPP for the most part result from the expiration of the CDWR contracts and from load growth. However, SDG&E has already executed contracts, such as the PPA for Otay Mesa, that will be replacing some of the capacity and energy that was previously provided by the DWR contracts.

DWR Contract	**Contract Size (RA Value MW)**	**End Date**
Cal Peak (Border)	43.8	12/31/2011
Cal Peak (El Cajon)	42.2	12/31/2011
Cal Peak (Enterprise)	45.5	12/31/2011
Sunrise	545.2	6/30/2012
Whitewater Energy - Cabazon	10.9	12/31/2013
Whitewater Energy – Whitewater Hill	14.9	12/31/2013
Williams A	200	12/31/2007
Williams B	450-275	12/31/2010
Williams C	50	12/31/2010

The RFO that SDG&E has identified in this LTPP to seek resources for the 2010 – 2012 time frame will, for the most part, provide SDG&E with the resources it needs to replace the DWR contracts. By issuing this RFO now, new as well as existing resources have an opportunity to replace this capacity in the portfolio. It should be noted

that, just because the CDWR contracts expire, it does not mean the resources behind these contracts have gone away. Thus, the resources currently behind the CDWR contracts are likely to be bidders in the IOUs' RFOs.

The near-term impact of the expiring CDWR contracts for SDG&E will be in the 2008 and 2009 time frame. As is noted in the cost discussion in Section VI, in this time frame SDG&E will lose power from must-take DWR contracts. The costs of these contracts are included in the fixed cost allocation that is shared across all three IOUs. While SDG&E's customers will need to pay the cost of replacing 100% of the energy, the cost savings from the expiration of the CDWR contracts is shared, and SDG&E's customers only receive about 10%.

Describe how the EAPII goal of 33% renewables by 2020 will be achieved.

SDG&E has described its renewables procurement efforts in the LTPP, and SDG&E's efforts have been very successful to date. SDG&E will have contracted for 20% of its customers' energy needs in 2010, including some additional capacity should all projects not perform as projected or on the time frame expected by developers. As such, SDG&E is at a point where it can look towards all-source RFOs as the standard procurement process. As described in Sections IV and V of the LTPP, SDG&E plans to continue renewables procurement beyond 20%. Just as with procurement limitations such as grid reliability, local RA requirements and system RA, the need to add renewable power can also be included, as either a specific set-aside or to meet GHG emissions goals.

SDG&E would also point out that the level of regulatory process addressing renewables procurement, both at this Commission and at the CEC, has required the IOUs

and all stakeholders to devote large amounts of time and resources to regulatory proceedings. At this juncture, SDG&E believes its time and effort could be more effectively spent by working on the actual procurement of renewables rather than on the regulatory processes surrounding renewables. SDG&E urges the Commission to streamline the renewables proceeding now that the renewables procurement effort has significantly matured since 2003.

Finally, SDG&E would also emphasize, as it has many times before, that new transmission is critical for SDG&E to meet its renewables goals. SDG&E therefore urges the Commission to move as quickly as possible in approving essential transmission infrastructure additions for SDG&E.

Section II. Procurement Practices

A. Competitive Procurement RFOs (McClenahan)

SDG&E outlines a plan in Volume I to move to all-source RFOs, thus eliminating the need to conduct "renewables-only" RFOs. SDG&E makes this recommendation because, once the targets for preferred resources have been met, it does not make sense to conduct the extra processes for a particular resource if targets can be built into the RFO requirements. As the process currently exists, the utilities are required to run and participate in different and separate processes for energy efficiency, demand response and renewable power, and then, when conducting RFOs, open them up to "all sources." Given this fragmented procurement structure, it is not surprising that all-source RFOs fail to result in resources other than fossil technologies.

Definition of "new" generation as a project with a 30 year life that is not yet under construction.

There should not be an established limit defining the life span of new generation. The Commission has urged supply-side diversity with a preferred loading order of resources. Certain of those resources, such as demand response, may well have life spans shorter than 30 years, and adoption of an artificial definition of "new" does not serve any obvious purpose. SDG&E also does not see the need to define a new resource as one that is not under construction. Any resource that is currently not providing power to the grid should be considered "new."

In light of new confidentiality rules, are RFOs public enough?

Yes. The RFOs issued by IOUs get substantial scrutiny from both the IE and PRG before being issued to ensure they are fair to all potential bidders. As described in Volume I, the IE review is included from the outset in creating the RFO and continues through receipt and review of bids, short-listing of bids, and supplier negotiations. Second, the PRG is apprised of each essential step along the way, including the potential need being filled, form of the RFO request, bid review and selection, and contract negotiations. Finally, the Commission reviews all transactions in either the Quarterly Transactions Report or when a transaction is submitted for Commission pre-approval. While it is not in the customers' best interests to release all of the details surrounding an RFO publicly, SDG&E includes ample detail in its public LTPP and the RFO so that potential suppliers and bidders have a solid understanding of SDG&E's current and future needs and how the bids will be evaluated. Moreover, SDG&E has extensively detailed over the last two years in particular the harm that can occur for SDG&E's customers if too much procurement information is released to the public in the context of

RFOs or otherwise (see generally, R.05-06-040 and CEC 2005 IEPR Docket No. 04-IEP-01D). SDG&E believes that ratepayers would potentially be harmed by the release of more information than is currently made public.

Should CPUC Require Submittal of RFOs to Energy Division in advance to ensure compliance with LTPP?

Prior to issuance RFO documents are generally made available for review by the PRG, which includes Commission staff and the IE is involved as well. To impose additional pre-approval obligations is unnecessary and could result in delays that may jeopardize the timely addition of resources.

Should the Commission adopt additional RFO policies that are consistent across all three IOUs?

It seems that to the extent RFO policies need to be consistent across IOUs (such as use of an IE), those details have already been established by the Commission. Any further attempt to standardize RFO policies or processes will complicate rather than advance procurement efforts by the utilities. In fact, SDG&E's experience to date is that flexibility improves the procurement process. Under RPS procurement, for example, which has been more highly prescribed, SDG&E does not see evidence that improved results have been achieved over conventional or all-source RFOs.

Is there a need to define "all-source" RFOs?

The term "all-source" is self explanatory and requires no further definition. However, while all-sources of supply are able to compete in IOU RFOs, the utility must nevertheless procure according to policy preferences and its portfolio needs. The Commission's least-cost best fit standard recognizes certain constraints on procurement. These constraints and this analysis would preclude, for instance, procurement of supply

outside of a utility's local area if the product being sought is local RA. In another example, a utility may pass up an otherwise economical renewable project, such as conventional solar PV, if it is procuring for off-peak needs. In short, while all sources of supply are free to bid in an all-source RFO, it is possible, even likely, that not all sources will be competitive due to various constraints.

B. Credit and Collateral Policies (McClenahan)

Currently, the Commission and the CEC (in separate but coordinated efforts) are undertaking an examination of the IOUs' credit policies in order to gain a better understanding of credit requirements as related to the electricity procurement process. Each IOU's procurement plan details the credit and collateral policies for different types of procurement for their respective electric portfolios. Since the last round of plans were adopted: (1) some of the IOUs' credit ratings have improved; (2) each IOU has gained significant experience in implementing its credit and collateral requirements; and (3) some parties have expressed concern at the level of credit and collateral requirement for IOU procurement.

Is it possible to have standard credit & collateral rules across all three IOUs?

No. Each IOU has its own corporate financial position, policies and constraints. Even standardizing credit and collateral rules across a single IOU's procurement transactions may be difficult given the unique nature of each counterparty. For instance, it is possible that while unsecured credit may be extended to some counterparties, it may not be available for all counterparties given their financial condition or the utility's overall exposure to that counterparty, taking into account all past transactions. Also, each highly structured transaction is unique and can contain different risks that make credit requirements different.

What are the different SCE-filed Settlement/Notice of non-settlement types of credit and collateral policies for the different types of IOU procurement and should there be consistency across the different types of procurement? (i.e. short-term transactions, up to 5-year RFOs, RPS RFOs, all-source RFOs, new-source RFOs)?

Are there alternative mitigation techniques that could be applied to resource procurement instead of the standard credit & collateral policies currently being utilized by the IOUs?

SDG&E conducts all credit reviews and creates credit requirements for counterparties to protect its ratepayers from potential losses resulting from default. Should the Commission attempt to dilute an IOU's credit requirements, ratepayers would be at greater risk for potential losses. The Commission should instead support ways to mitigate credit exposure, such as through credit clearing mechanisms, as described in Volume I.

C. Independent Evaluator

Should all competitive solicitations require an IE?

SDG&E used an independent observer in its 2003 Grid Reliability RFP. Since that time, SDG&E has had positive experiences with the IE, as described in Volume I. While it is not necessary to mandate use of an IE in every RFO, SDG&E has found the IE's participation to be valuable, as described in Volume I.

Should solicitations that do not have affiliate transactions, or involve a utility owned or utility-turnkey bid require an IE?

See above.

How can the Commission ensure the impartiality of the IE?

The Commission staff is involved in selection of the IE through its participation on the PRG. Furthermore, the PRG reviews and discusses RFO progress during PRG meetings and remains involved throughout the procurement process. The Commission

and its staff also have the ability to contact the IE at any point for an update and to review IE reports at the conclusion of an RFO. Lastly, the Commission reviews the RFO results, so it can form its own opinion as to how well the IE performed.

What are the costs and benefits associated with the use of an IE, and how do those benefits directly affect procurement outcomes?

SDG&E has not conducted an IE cost/benefit analysis because use of the IE is a Commission requirement. Benefits associated with the use of an IE, which are largely intangible and difficult to quantify, include increased confidence on the part of market participants in utility procurement practices, which theoretically should increase participation, and enhanced review and evaluation of RFO offers and the surrounding process. SDG&E has also found that having the IE review and check the process and evaluation as it moves forward will help ensure that the end results are correct. Also, no matter how well-designed the RFO and evaluation process, issues will come up during the process. By having an IE available to discuss the issue and assess what resolution would be fair to all bidders, the RFO can move forward and result in actual procurement in a more timely manner.

D. Implementation of AB 1576 (Anderson)

AB 1576 relates to rate recovery for repower or replacement generation contracts that might be entered into pursuant to the normal resource and procurement planning processes established in AB 57. The statute does not call for separate implementation proposals for repowers or replacement generation that would displace the otherwise applicable resource planning process that has been implemented by the Commission since AB 57 was adopted. Along these lines, Section 454.6 provides in pertinent part as follows:

> 454.6(a) A contract ***entered into pursuant to Section 454.5*** by an electrical corporation for the electricity generated by a replacement or repowering project that meets the criteria specified in subdivision (b) shall be recoverable in rates, taking into account any collateral requirements and debt equivalence associated with the contract, in a manner determined by the commission to provide the best value to ratepayers. [Emphasis added.]

The statute goes on to describe the criteria for these contracts to be eligible for the rate treatment described in (a). Thus, as the above-quoted language makes clear, there is no change to the existing Section 454.5 procurement and resource planning process the Commission is undertaking in this docket that requires singling out replacement or repower resources for early and separate treatment.

How do the IOU procurement plans provide for the potential repowering of existing facilities?

Through the LTPP, the IOUs identify the needs and types of resources that will best serve bundled customers and outlines the process it will use to fill that need. Once the Commission adopts the plan, the IOU can then move forward with its procurement activities. In this LTPP, SDG&E has identified its future need and the processes to procure for this need. Owners of existing units that wish to use the elements of AB 1576 as part of their bids may do so. AB 1576 does not require the IOU to reject lower cost offers that meet the identified need just because a higher cost offer claims to meet the AB 1576 requirements.

How do the IOU procurement plans allow for potential use of AB1576 to allow for repowering?

AB 1576 does not pertain to the resource and procurement planning process, but only the cost recovery process. Therefore, nothing needs to be done in the resource planning and procurement proceeding as a result of AB 1576.

In D.04-12-048, p.159, the Commission directed the IOUs to consider the use of brownfield sites first and take full advantage of their location before they consider building new generation on Greenfield sites. Describe how the IOUs have been able to implement this requirement and whether it should be continued.

The ability to take full advantage of brownfield sites lies with the owner of the site, which in most cases is not the IOU. SDG&E's long-term procurement, except for renewable power, has been very limited since this requirement was passed. However, SDG&E was able to make use of a brownfield site with the development of the Miramar Energy Facility, which was built next to existing combustion turbines. In this LTPP, SDG&E has identified its future need and the processes to procure for this need. Owners of existing brownfield sites may bid into the future RFOs outlined in this LTPP.

SDG&E does not believe that additional special considerations for brownfield sites are necessary. The RFO evaluation process that considers all costs, including any needed transmission to make a plant's power deliverable, adequately weighs all proposals. If existing brownfield sites offer particular advantages, then those advantages should be reflected in the bid price and in the evaluation process.

Does the Commission need to adopt guidelines as to what qualifies as repowering (e.g., an engineer certification of at least a 30-year design life)?

SDG&E does not see the need to adopt guidelines as to what qualifies as a repower. The RFO process looks for the lowest cost resources to meet the need.

How do the State's water policies, including the evolving policies on once through cooling affect the process of repowering aging power plant facilities?

The State's policies to eliminate once-through cooling have a major impact on the desirability of various existing power plant locations. Power plants used to be located near large bodies of water, such as oceans or lakes, in California because the steam-based technology required large amounts of water for cooling. Given the State's evolving

policy, a power plant developed on an existing site along the shore would likely need to find a new source of cooling water. Thus, one of the major driving factors for why the old plant was located where it was to begin with would no longer apply to the repower. Some power plant owners may also find that the power plant site has a better and higher use for another type of development.

Section III. Risk Management Practices (McClenahan)

A. Gas Hedging Strategies for Electric Procurement Portfolios

SDG&E sees no need for the Commission to create a unified hedge strategy for adoption by all three utilities. A different hedge strategy by each utility is inevitable because each organization has a different portfolio that requires strategies to be tailored to individual needs. Also, each organization will have a different outlook for the future, which will cause different reactions to the same market information; these factors will necessarily result in differences in each utility's risk management strategy.

The Commission should recognize that differences in managing risk have not resulted, to SDG&E's knowledge, in disproportionate utility impacts. While results for each utility's customers will vary, diversity of risk strategy among the IOUs represents a desirable "statewide" hedge. If all IOUs shared a common strategy, then any "perfect storm" of bad market events could have a far greater impact if that common strategy was particularly susceptible to those specific market upsets.

B. Application of TeVaR to Measure the Customer Risk Tolerance Threshold

SDG&E understands the intent of the Commission's direction to calculate and report a VaR-to-Expiration (VtE) as a metric of portfolio risk and will continue such

reporting. However, the Commission should not be prescriptive in how this number is used in IOU decision-making.

VtE is an interesting data point, but it is only one of a variety of ways to view risk. VtE looks at the potential peak exposure of customers' costs to rising prices over the life of positions. It is not, however, appropriately applied to all risk decisions. An IOU may wish to use a shorter time horizon for calculating VaR for other purposes. For example, SDG&E uses a 1-day VaR to look at the potential margin requirements associated with its positions because this cash management activity (posting of margin) is handled on a daily basis. The time interval associated with VaR is akin to driving at night – in some instances it is prudent to drive with headlights set on high beams, i.e., VtE and, in others, it is wiser to use low beams, i.e., a shorter term VaR, such as one- or ten-day.

SDG&E recommends that the IOUs continue to report whichever VaR metric(s) the Commission wishes to see; however, the Commission should recognize the situational use of VaR and not limit a single VaR measure to be used in all risk management decision-making. A more reasonable approach is to continue to calculate, monitor and report on VtE as a strategic view for the potential risk to customer costs and an indicator of how aggressively SDG&E will apply incremental hedging.

In addition to the continued current use of VtE, SDG&E proposes to implement a 10-day VaR for use in the CRT-VaR methodology. This CRT-VaR (10-day) will be used for tactical decision-making, particularly for deciding when to increase hedges to protect remaining CRT. This approach will lead to increased flexibility in the ability of SDG&E to manage the risk to customer rates because the risk of adverse price movements over 10

days still provides SDG&E ample opportunity to properly identify, assess and implement appropriate risk management strategies to manage to the CRT stop-loss.

In response to the specific Commission questions:

1. *Should the Commission standardize how the three IOUs are calculating TeVaR and using it in their procurement plans?*

TeVaR is primarily a tool for the Commission to assess potential risk to each IOU's customer rates. As such, standardization may enable the Commission to more appropriately utilize TeVaR by better understanding the implication or significance of the results. However, SDG&E cautions against expectations that results will be fully comparable across all three IOUs even if standardization were attempted. Certainly results would be more comparable than they are today; however, without standardizing the pricing assumptions, portfolio duration (and hence CRT management approach), and position mapping methodology, it is unclear how comparable the results could ever be.

2. *Should TeVaR be calculated on a rolling 12 month basis, and/or on the basis of the next full calendar year?*

SDG&E will calculate VtE (presumably the same as TeVaR) in whichever manner the Commission requires for strategic assessment of risk. SDG&E's CRT strategy has, since 2003, been structured around managing portfolio costs over calendar years. A rolling 12-month CRT window is not conducive to applying CRT to periods beyond one year. SDG&E currently reports a rolling 60 month VtE to the Commission and certainly can provide a rolling 12-month analysis as well. However, SDG&E would continue to calculate VtE over the calendar year periods for a more relevant internal reference. If the Commission is interested in aligning the risk window across the three utilities it would need to align the relevant portfolio management horizons as well.

3. *Should the Commission refine the use of TeVaR to be at the 95% interval instead of the 99%?*

As stated elsewhere, different confidence levels are appropriate for different circumstances. The 95% interval gives a more reasonable assessment of risk to customer rates. SDG&E is concerned that the 99% interval, based on current market and historical data, can give an inappropriate sense of security. The scale of 1-in-100 type events is not likely to be well-predicted over the "to expiration" horizon based on known data. These crises events tend to be unique.

4. *Should the Commission extend the use of TeVaR beyond 1 year, to 5 years or longer?*

The Commission already requires the use of VaR to measure portfolio risk over a 60-month period. As discussed earlier, because TeVaR increases in proportion to the square root of time, the extension of TeVaR to those time frames would essentially result in nonsensical and unusable outcomes and, if taken to an illogical extreme, potentially result in significant levels of hedging through those time frames.

5. *Are there more appropriate measurements of risk tolerance for the long-term horizon?*

As evidenced with the amount and type of long-term hedges in its portfolio, SDG&E proposes that a more appropriate measure for the longer-term horizon is to set a floor on long-term fixed price positions, to at least a small amount, while maintaining a blend of index-based hedges to maintain reliability and contract for environmental concerns. SDG&E believes it is not prudent to either commit too much or too little to fixed-price hedging for the long-term as either of these requires the ability to effectively speculate on both the direction and timing of market price movements.

Section IV. Other Testimony in Support of Procurement Policies and Plans Suggested Process Improvements

The Commission is involved in taking a fresh look at procurement through this LTPP. This effort is an important opportunity to create positive changes. Many of the current rules were put together in a relatively short period of time as the Commission worked to establish a regulatory framework that allowed the IOUs to resume procurement on January 1, 2003. There have been subsequent decisions that attempted to clarify rules, but the Commission now has an opportunity to learn from four years of practice and adopt changes that will maintain proper regulatory oversight while eliminating duplicative workload on the Commission and those under its jurisdiction.

In general, the Commission should avoid unnecessarily splitting LTPP issues into numerous sub-proceedings, each with multiple phases. This proliferation results in duplicative resource burdens, can lead to conflicting decisions, forum shopping, or a lack of key decision-making as difficult issues are moved from one proceeding to another. Lastly, this multitude of proceedings places a strain on resources for the Commission and all stakeholders that could be better deployed to advance the State's and customers' best interests. Thus, SDG&E urges the Commission to use this proceeding to make the process improvements discussed below.

A. Consolidate Renewables-Only Procurement Plans into the LTPP Process (McClenahan)

The goal of the Commission in this LTPP is to consolidate all procurement decisions, processes, and strategies into a single guidebook for procurement that is an AB57 upfront plan for IOU procurement. As such, further "renewables only" procurement plans should be abandoned, and renewables procurement activity should be

folded into this LTPP process with procurement taking place through all-source solicitations once the applicable targets and goals are met.

Elimination of the renewables-only procurement plans and RFOs in no way reduces SDG&E's commitment to procuring environmentally sound resources. The Commission has often sent conflicting messages, however, at times urging use of all-source RFOs while at other times requiring renewables-only RFOs. A better approach would be for the Commission to set goals and for the IOUs to incorporate the goals into all-source RFOs to ensure a true least-cost best fit of supply resources.

B. Consolidate Gas Supply Plans into the LTPP Process (McClenahan)

In this LTPP, SDG&E discusses its gas positions (both CDWR and IOU), process and strategy for procuring gas, strategies for managing gas price risk, as well as how SDG&E manages the gas portfolios of CDWR and SDG&E as a single integrated portfolio as required under Standard of Conduct #4. This comprehensive showing should be sufficient to eliminate the need for the semiannual filing of CDWR fuel supply plans. SDG&E can think of no reason to continue this duplicative effort, which requires extensive time for the utility to prepare and the Commission to review. SDG&E meets weekly by teleconference with CDWR and either party can raise and resolve any issues, including those related to gas. Any need for updates between LTPPs could be handled by either data request or through the submission of updates to positions in the "off" year of the LTPP process. Any changes to strategy or process would be filed as an update to this LTPP.

C. Consolidate Compliance Reviews Through Combining the Quarterly Transaction Reports and the ERRA Annual Review Filing (McClenahan)

The Commission's compliance review, which confirms that an IOU procured in accordance with the upfront standards found in its AB 57 Procurement Plan, spans both a year-end ERRA review as well as the Quarterly Procurement Transactions Report. While the Commission has clarified that certain types of transactions are reviewed in each process, mostly distinguished by timing of the transactions, there remains considerable duplication of effort and documentation. A far more efficient solution would be the replacement of the Quarterly Reports with review of all transactions in the year-end ERRA. Currently, Quarterly Reports are reviewed very late, often after a final Commission decision has already been issued in the ERRA proceeding.

D. Renewable Energy Credits (RECs) (McClenahan)

The Commission should move expeditiously to approve the IOU trading of RECs. Many detractors are laboring under the impression that RECs will reduce the addition of new renewables generation. The Commission needs to recognize that RECs enhance renewables project returns by allowing for the sale of any "odd lots" of generation; that is, a project may sell a portion of its output and have a difficult time finding a buyer for the remainder, which may be in undesirable hours. RECs allow for the project developer to realize both the energy value, through a day-ahead or imbalance market, as well as the renewable value through a sale of associated RECs. Further, a forward sale of RECs, separate from the energy, is simply a structured transaction that allows the project more flexibility in securing a forward contract while retaining the same forward revenue certainty that will allow new construction.

All RECs require a source from a renewable generator – if 100% of an LSE's renewables procurement were filled through RECs, it would require the same amount of renewable energy as if RECs were not allowed. The Commission must act quickly to ensure that this important flexible compliance mechanism is available to IOUs and other LSEs. Such flexibility may be very important to meeting and exceeding renewables targets. This occurs because the purchase of renewables generation (as opposed to RECs) may create redundant resources any time that a utility already has a fully-sourced portfolio in a given year, but has not met its renewables goal. RECs would also be easier for smaller LSEs, who could buy portions of a project rather than an entire project. RECs offer a flexible and economically sound means of ensuring that renewables goals can be met in a true least-cost best fit manner. SDG&E assumes in this plan that it may sell RECs at any time to realize customer value; it is only the buying of RECs that will require a change in Commission rules.

E. Confidentiality (McClenahan)

The Commission has made important decisions regarding the need to protect IOU ratepayers through confidential treatment of certain sensitive IOU procurement data. SDG&E recommends that the Commission clarify that Declarations for confidential protection are not required outside of formal proceedings, such as large Commission audits where no other party participates or for PRG meetings. SDG&E also urges the Commission to work with its sister agencies to ensure that a consistent framework for confidentiality applies across such agencies.

F. Incentive Mechanism (McClenahan)

SDG&E supports appropriately formulated, performance-based incentive programs that align the interests of ratepayers and shareholders. Additionally, a

well-crafted incentive mechanism would be the best "up-front standard and criteria by which the acceptability and eligibility for rate recovery of a proposed procurement transaction will be known by the electrical corporation prior to execution of a transaction" (Public Utilities Code Section 454.5). As such, SDG&E conducted workshops with other interested parties to craft incentive mechanisms early on in this proceeding (see Workshop Reports filed on February 18 and April 15, 2003). SDG&E sought to file a proposal with the Commission for implementation of an incentive mechanism to apply to all electric procurement activities effective January 1, 2004. That effort did not materialize due to the focus shifting to a GHG cap and trade program. SDG&E intends to reinvigorate efforts to establish more general electric procurement mechanisms, as envisioned in AB 57, and as are currently successfully employed in core gas procurement.

G. Restrictions on Bilateral Contracting Should Be Eliminated (McClenahan)

In D.03-12-062 (pp. 39-40), the Commission placed the following limits on bilateral contracting: (1) for short-term transactions of less than 90 days duration and less than 90 days forward, the IOUs are authorized to continue to use negotiated bilaterals subject to the strong showing standard adopted in D.02-10-062, as modified by D.03-06-067, and any such negotiated bilateral transactions shall be separately reported in the utilities' Quarterly Reports; (2) to purchase longer term non-standard products provided they include a statement in the Quarterly Reports to justify the need for a non-standard product in each case; the justification must state why a standard product that could have been purchased through a more open and transparent process was not in the best interest of ratepayers; and (3) for standard products in instances where there are five

or fewer counterparties who can supply the product. This authority is limited, however, only to gas storage and pipeline capacity. The Commission should relax these constraints on the use of bilateral contracts and allow for the use of bilaterals of up to five years duration without Commission pre-approval.

SDG&E proposes that the standard for evaluation of any bilateral contract be a showing that the product purchased was consistent with market prices for that product at the time that the term and conditions for the product (especially price) were agreed to. SDG&E will rely primarily on three means of establishing that the purchase price was consistent with market. First, SDG&E will perform analysis (and submit it as part of the ERRA) that benchmarks the product purchased to a public index, with an explanation and valuation of any basis (accounting for any difference between the product traded in the index and the product traded by SDG&E bilaterally) associated with the use of that index. Second, SDG&E will compare the contract to offers received for similar products in other procurement transactions conducted by SDG&E through a competitive solicitation. Lastly, SDG&E will conduct an abbreviated solicitation through appropriate means to canvass a number of market participants simultaneously. Any bilateral contract that is purchased using benchmarks that are consistent with these valuations will be considered reasonable and equivalent to using a transparent exchange, therefore removing the need for Commission limits on bilaterals.

H. Cost Recovery Issues (Schneider)

In this section, SDG&E presents a proposal for calculation and recovery of costs associated with both debt equivalence and Financial Accounting Standards Board (FASB) Interpretation No. 46(R) (FIN 46(R)) for resources procured during the term of this LTPP. Because this section incorporates discussion of both existing, approved

processes as well as new proposals, SDG&E is including this section in both Volumes I and II. SDG&E describes below a proposed methodology for calculating and recovering debt equivalence costs associated with Power Purchase Agreements (PPAs). This methodology is based upon the direction provided in D.04-12-048 (Ordering Paragraph No. 26 f), "Debt equivalency will be considered when evaluating PPA bids," and will be updated using Standard & Poor's (S&P's) most recent calculation methodology. In addition, SDG&E provides an overview of the requirements and costs associated with FIN 46(R) financial consolidation,[1/] and presents SDG&E's cost recovery proposal for rebalancing its capital structure to the authorized structure.

SDG&E requests that the Commission approve the proposed methodology for calculating costs associated with debt equivalence and FIN 46(R), so that the utilities have clear guidance on how to incorporate these costs when evaluating bids. In addition to benefiting from sound economic evaluation of bids that ensure the utilities select the best energy resource alternative, SDG&E believes that customers also benefit from a portfolio of procurement resources that is diversified with respect to contract types, including both ownership options and PPA contracts, consistent with the "hybrid market" structure in place in California.

Despite the costs associated with debt equivalence or potential consolidation of an entity under FIN 46(R) resulting from PPAs, SDG&E considers PPAs an attractive option that mitigates construction and cost escalation risks associated with building and operating a new facility. However, AB 57 states that, "the commission may not approve

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[1/] In the event SDG&E consolidates an entity in accordance with FIN 46(R), the rating agencies would evaluate credit ratings for the utility based upon the consolidated financials, and would not assess debt equivalence costs for that contract. Thus, rating agencies consider either FIN 46(R) consolidated financials or assess debt equivalents associated with PPAs, not both.

a feature or mechanism for an electrical corporation if it finds that the feature or mechanism would impair the restoration of an electrical corporation's creditworthiness or would lead to the deterioration of an electrical corporation's creditworthiness." Therefore, SDG&E requests that the Commission adopt the cost recovery proposals presented below to provide a mechanism to ensure timely recovery of the costs associated with rebalancing SDG&E's capital structure to the authorized capital structure.

Debt Equivalence

Definition and Applicability

Rating agencies include long-term fixed obligations such as PPAs in their credit risk analysis in order to conduct a meaningful comparison between utilities that build generation and utilities that enter into PPAs. These obligations are treated as additional debt during the financial ratio assessment.

As part of its credit review, S&P evaluates three ratios as critical components of a company's credit profile: (1) Funds From Operations (FFO) / Debt, which measures how many years it would take for a company to repay all of its debt with internally generated cash flows; (2) FFO / Interest Expense, which measures the "headroom" a company has in fulfilling its current interest payments; and (3) Debt / Capitalization, which is a financial leverage indicator and measures how much cushion equity provides in fulfilling a company's total debt obligations. Debt equivalence negatively impacts all three ratios. Thus, unless mitigated, a PPA will negatively impact SDG&E's credit profile evidenced by degraded credit ratios. On November 1, 2006, S&P published refinements to its methodology for calculating debt equivalence associated with PPAs, as described in further detail below.

Current Commission Guidance Related to Debt Equivalence

The Commission has previously recognized that failing to include the costs associated with debt equivalence in a utility's resource procurement analysis will distort the true economics of various resource options, contributing to higher costs for ratepayers in the long run. Specifically, the Commission stated that "DE is a real cost that needs to be considered when evaluating bids from a PPA vs. a utility-owned resource" (D.04-12-048, p. 131). The Commission instructed the utilities to "take into account the impact of DE when evaluating individual bids in an all-source and RPS RFO, regardless of whether it is a fossil, renewable, or an existing QF resource" (D.04-12-048, p. 132). The Commission ordered use of the S&P methodology for calculating debt equivalence, except for adopting a 20% risk factor rather than S&P's 30% (D.04-12-048, p. 221).

SDG&E agrees that it is critical to include debt equivalence costs in the bid evaluation process to ensure an accurate comparison of the economics of diverse resource options. However, SDG&E proposes that the methodology for calculating debt equivalence be modified to correspond to the updated S&P methodology.

S&P Methodology for Calculating Debt Equivalence

S&P determines the debt equivalence that it will add to a utility's balance sheet as a result of entering into a PPA by calculating the net present value (NPV) of the annual capacity payments over the life of a contract. Where the annual capacity payments are specified in the contract, S&P employs that information to calculate debt equivalence. Where the PPA contract payments are unspecified or stated as a single, all-in energy price, S&P uses a proxy capacity charge, stated in dollars per kW/yr, and multiplies that charge by the kW under contract. The proxy capacity charge is based on the prevailing cost to develop and finance a combustion turbine, which is considered the marginal unit

of energy. S&P discounts the remaining capacity payments using the utility's average cost of debt to determine the NPV of the remaining fixed payments. The NPV of the remaining fixed payments is multiplied by a risk factor assigned by S&P to determine the debt equivalence associated with a PPA. S&P assigns different risk factors to represent its view of the likelihood that the utility will fully recover PPA costs on a timely basis. For purposes of evaluating SDG&E's PPA contracts, S&P uses a risk factor of 25%.

S&P adds a PPA debt equivalent to SDG&E's other debt and PPA's associated imputed interest expense to SDG&E's interest expense. In addition, S&P adds an implied depreciation expense to FFO when calculating FFO / Interest Expense and FFO / Debt ratios in order to align the analytical treatment of PPAs with the concept of purchased power as a substitute for utility ownership. SDG&E proposes that the Commission adopt the most recent S&P methodology for calculating debt equivalence in order to accurately reflect the costs associated with debt equivalence when comparing bids, as described in Exhibit VII-1. Examples of the S&P calculations are shown in Exhibits VII-2 and VII-3.

Cost Recovery for Debt Equivalence

In D.05-12-043 (the 2006 Cost of Capital decision), the Commission stated that "we must ensure that the utilities' adopted equity ratios are sufficient to maintain reasonable credit ratings and to attract capital" (p. 4) and that SDG&E's currently authorized capital structure is "…balanced, intended to maintain an investment grade rating, to attract capital, consistent with the law, in the public interest…" (pp. 11-12). Although the Commission recognized in D.04-12-048 that debt equivalence imposes a real cost on the utilities and should be taken into consideration in the economic evaluation of bids, up to this point the Commission has not prescribed an explicit

methodology for the utilities to evaluate and recoup costs associated with debt equivalence that ensures timely cost recovery and statewide consistency.

While conceptually the implementation of debt equivalence mitigation can be addressed in annual Cost of Capital (COC) proceedings, under SDG&E's MICAM it is likely SDG&E will process a full COC only every five years. Therefore, for SDG&E, it is appropriate that the Commission address debt equivalence mitigation for a PPA at the time the PPA is presented to the Commission for approval. This will allow for timely review and implementation of appropriate mitigation measures.

This proposal is consistent with the legislative direction to the Commission expressed in AB 57 that a utility be ensured "timely recovery of prospective procurement costs" through "upfront standards and criteria by which the acceptability and eligibility for rate recovery of a proposed procurement transaction will be known by the electrical corporation prior to execution of the transaction" and be protected from any feature or mechanism that "would lead to a deterioration of an electrical corporation's creditworthiness." Waiting until SDG&E's next COC proceeding to implement credit mitigation will not ensure in most cases SDG&E's ability to recover its costs associated with approved PPAs in a timely manner, especially when the next COC proceeding is significantly beyond the approval date of a new contract.

Therefore, SDG&E proposes that the specific procedure set forth herein be adopted, which would allow use of the most recent S&P methodology for calculating debt equivalence. By adding equity in an amount equal to the authorized equity factor (currently 49%) of the additional debt and reducing debt by the same amount, SDG&E will resume the authorized capital structure. Using the authorized cost of equity

(currently 10.7%), factoring in the gross-up for income tax expense and the authorized cost of debt (currently 5.75%), SDG&E can calculate the revenue requirements associated with rebalancing. In the event of changes to the currently authorized capital structure and cost of capital, SDG&E would substitute the future authorized levels in the debt equivalence calculation. Exhibit VII-1 describes the calculation of revenue requirements associated with debt equivalence and exemplary calculations are shown in ExhibitsVII-2 and VII-3.

Financial Impact of FIN 46(R)

Definition and Applicability of FIN 46(R)

The FASB issued FIN 46(R), *Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51*, in 2003 to provide guidance on the identification of and financial reporting for entities over which control is achieved through means other than voting rights. Such entities are known as variable-interest entities (VIEs). In accordance with the requirements of FIN 46(R), the financial statements of a power provider that meets the definition of a VIE needs to be consolidated with the financial statements of the power purchaser if it is determined that the power purchaser is the Primary Beneficiary (see definition below in Step 2).

In accordance with FIN 46(R), an entity is considered a VIE if any of the following factors are present:

- The equity investors lack the risks or rewards of ownership (a cap or floor exists on expected losses or gains); or
- The equity investors have not invested enough for the entity to stand on its own without additional support.

If an entity is a VIE, then it is determined whether SDG&E is the Primary Beneficiary. FIN 46(R) defines the Primary Beneficiary as the party that (1) absorbs a

majority of the expected losses; (2) receives a majority of the expected residual returns; or (3) both. In other words, the Primary Beneficiary absorbs a majority of the negative or positive variability in cash flows generated by a VIE.

Recent Developments

It is possible that renewable PPAs are within the scope of FIN 46(R) due to the commodity price risk absorbed by the PPA holder. Previously, PPAs containing fixed payment terms were considered to be out of scope for FIN 46(R) because costs to the utility were known and not subject to variability. If this position were to change, renewable PPAs signed after July of 2006 would be subject to the new interpretation. SDG&E is negotiating and soliciting bids for new renewable contracts that could be impacted if FIN 46(R) applies. It is imperative that SDG&E preserve its credit ratings and maintain a solid balance sheet to support planned infrastructure growth while entering into renewable PPAs to reach its RPS goals. Therefore, SDG&E requests that the Commission approve the proposal for calculating costs associated with FIN 46(R) consolidation, as well as the associated cost recovery proposal.

Financial Consolidation Impacts and Costs

If SDG&E is determined to be the primary beneficiary of a VIE, SDG&E will be required to consolidate the financial statements of that entity when filing annual and quarterly reports with the SEC. The effective date of the consolidation may be as early as the date when the new agreement becomes effective, enforceable and no longer subject to any conditions precedent to performance.

As a result of this requirement to consolidate the financial statements of an entity with the financial statements of SDG&E, upon completion of the plant construction, the total assets, liabilities and minority interest on SDG&E's consolidated balance sheet are

expected to increase. Minority interest will be shown as a new line item reflecting the entity's equity amount, which will change based on operating results and the amount of investment capital at risk. SDG&E is required to reflect all changes in the entity's assets and liabilities on its balance sheet on an ongoing basis when reporting its financial position on a consolidated basis.

SDG&E's capital structure on a consolidated basis would be misaligned with its authorized capital structure after consolidating an entity that is highly leveraged into its financial statements. As a result, SDG&E would need to increase its equity to offset the impact of the additional debt. Rebalancing its capital structure to the authorized structure would result in additional costs to be recovered in rates. The Commission recognized this requirement in D.06-09-021, and authorized SDG&E to "recover the costs …. associated with the equity rebalancing SDG&E deems necessary due to filing and reporting requirements of FIN 46(R) and the consolidation of OMEC financial data with SDG&E's quarterly and annual financial statements to the Securities and Exchange Commission" (Ordering Paragraph No. 4, pages 18-19). SDG&E's cost recovery proposal applicable to FIN 46(R) is illustrated in Exhibit VII-4.

Contractual Mitigation Option

For contracts subject to FIN 46(R) consolidation, SDG&E plans to pursue contractual mitigation measures to minimize negative impacts to SDG&E's balance sheet. If a counterparty finances its project in a manner consistent with SDG&E's capital structure, FIN 46(R) impacts will be immaterial because the minority interest is treated as equity by the rating agencies. Consequently, SDG&E plans to request contractual limits on the percentage and/or amount of leverage. If a counterparty cannot lower its leverage,

then SDG&E would request recovery of the additional costs due to consolidation at the time the contract is submitted for Commission approval.

Cost Recovery Proposal for FIN 46(R)

It is imperative that SDG&E preserve its credit ratings and maintain a solid balance sheet to support planned infrastructure growth while entering into renewable PPAs to reach its RPS goals, replacing CDWR contracts due to expire, and securing contracts to meet projected growth in energy demand. Potential consolidation under FIN 46(R) imposes significant risk of degrading SDG&E's credit ratios. The Commission approved SDG&E's ratemaking proposal for costs associated with rebalancing its capital structure due to FIN 46(R) consolidation in D.06-09-021. The Commission did not, however, authorize this mitigation measure for all future projects, which exposes SDG&E to cost recovery risk when negotiating similar transactions. Therefore, SDG&E proposes to include the revenue requirement associated with FIN 46(R) consolidation in the advice letter filings for approval of PPA contracts in order to ensure timely and equitable assurance of cost recovery as set forth in Exhibit VII-4.

The exemplary calculation in Exhibit VII-5 shows that SDG&E, while treating minority interest as equity, needs to further increase equity to offset the additional debt in order to rebalance its capital structure to the authorized structure. By adding equity in an amount equal to the authorized equity factor (currently 49%) and reducing debt by the same amount, SDG&E will resume the authorized capital structure. Using the authorized cost of equity (currently 10.7%), factoring in the gross-up for income tax expense and the authorized cost of debt (currently 5.75%), SDG&E can calculate the revenue requirements associated with rebalancing. In the event of changes to the currently

authorized capital structure and cost of capital, SDG&E would substitute the future authorized levels in the FIN 46(R) revenue requirement calculation.

I. Conclusion

SDG&E agrees with the Commission that it is necessary to include debt equivalence costs in the economic evaluation of bids, in order to conduct a meaningful comparison among diverse resource options. SDG&E requests that the Commission adopt the revised S&P methodology for calculating debt equivalence presented here and the associated cost recovery proposal described in Exhibit VII-1. Furthermore, the Commission has previously recognized and approved recovery of costs associated with FIN 46(R) consolidation, but has not yet extended that policy to all future transactions. SDG&E requests that the Commission authorize SDG&E to include revenue requirements associated with rebalancing its capital structure to the authorized capital structure as a result of FIN 46(R) consolidation when filing for approval of PPA contracts as described in Exhibit VII-4 to ensure timely recovery of procurement-related costs and preserve SDG&E's credit profile.

QUALIFICATIONS

My name is Robert B. Anderson. My business address is 8330 Century Park Court, San Diego, California, 92123.

I am employed by San Diego Gas & Electric Company as Director - Resource Planning. My responsibilities mainly include electric resource planning. I have been employed by SDG&E since 1980, and have held a variety of positions in resource planning, corporate planning, power plant management, and gas planning and operations.

I have a BS in Mechanical Engineering and a MBA - Finance. I am a registered professional engineer in Mechanical Engineering in California.

I have previously testified before this Commission.

QUALIFICATIONS

My name is Mike McClenahan. My business address is 8306 Century Park Ct, San Diego, California, 92123-1593. I am employed by SDG&E as Director, Procurement and Portfolio Design. My responsibilities include long-term procurement, incorporating regulatory and policy issues into commercial transactions, and portfolio planning. I joined the Electric and Gas Procurement group in September 2002.

I received my Bachelor's Degree in Industrial Technology from the California Maritime Academy. My career in electricity has spanned a broad range of functional areas – generation operations, power system control and transmission operations, system resource planning (real-time to two year time horizon), commercial operation (trading and risk management), market analysis, business development and market design/regulatory efforts in all major U.S. markets and several Asian markets. I have worked in both regulated (SDG&E and PG&E) and unregulated (Mirant) energy companies as well as a market service provider (Automated Power Exchange).

QUALIFICATIONS

My name is Michael M. Schneider. I am employed with San Diego Gas & Electric Company as the Director of Financial Strategy and Analysis for SDG&E and Southern California Gas Company. My business address is 8330 Century Park Court, San Diego, California 92123-1530.

I received a Bachelor of Economics degree from the University of Arizona in 1987. I received a Masters of Business Administration from George Mason University with an emphasis in finance and accounting in 1990. I have been employed by SDG&E since 1992. I have held various positions throughout my almost 15 years with SDG&E, including pricing analyst, regulatory case manager, Manager of Pricing, Director of Business Analysis, and Director of Business Planning and Budgets.

In my current capacity, I am responsible for financial and economic assessment of the utilities' business functions and activities related to operations, capital investments, financing and regulatory proceedings.

I have previously testified before both the Federal Energy Regulatory Commission and California Public Utilities Commission.